DEPARTMENT OF STATE REVENUE

02-20100170.LOF

Letter of Findings: 10-0170
Corporate Income Tax
For the Years 2005, 2006, 2007

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ISSUES

I. Corporate Income Tax – Required Combination.

Authority: IC § 6-8.1-5-1; IC § 6-3-2-2; Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer protests its combination with a related entity for purposes of its Indiana Adjusted Gross Income Tax ("AGIT").

II. Tax Administration – Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of a ten percent negligence penalty.

III. Tax Administration – Underpayment Penalty.

Authority: IC § 6-3-4-4.1.

Taxpayer protests the imposition of a ten percent underpayment penalty.

STATEMENT OF FACTS

Taxpayer is a retailer with outlets in Indiana. Taxpayer is a limited partnership commercially domiciled out of state. Taxpayer has elected to be taxed as a C corporation. Taxpayer is owned by two entities ("XXX Co." and "YYY Co."). XXX Co. and YYY Co. are in turn owned by the group's holding company ("Holding Co."). For federal income tax purposes Taxpayer reports as a consolidated group reporting under Holding Co. Taxpayer files a separate return in Indiana.

The Indiana Department of Revenue ("Department") audited Taxpayer for income tax for FYE 2/26/2005, FYE 2/26/2006, and FYE 3/3/2007. The Department found that Taxpayer's reported income tax for the years at issue did not fairly represent its income earned in Indiana and therefore required Taxpayer to file a combined return with an entity that sold merchandise to Taxpayer and provided certain services to the members of the group ("ZZZ Co."). Taxpayer protested the required combination. The Department conducted an administrative hearing and this Letter of Findings results. Additional facts will be provided as necessary.

I. Corporate Income Tax – Required Combination.

DISCUSSION

The Department required Taxpayer to file a combined return with ZZZ Co. for the years at issue in order to fairly reflect its income earned in Indiana. Taxpayer protested the required combination.

The Department notes that all tax assessments are presumed to be accurate and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(b); Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

IC § 6-3-2-2 states in relevant part:

(l) If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(1) separate accounting;

(2) for a taxable year beginning before January 1, 2011, the exclusion of any one (1) or more of the factors, except the sales factor;

(3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or

(4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

(m) In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

...

(o) Notwithstanding subsections (l) and (m), the department may not, under any circumstances, require that income, deductions, and credits attributable to a taxpayer and another entity be reported in a combined income tax return for any taxable year, if the other entity is:

(1) a foreign corporation; or

(2) a corporation that is classified as a foreign operating corporation for the taxable year by section 2.4 of this chapter.

(p) Notwithstanding subsections (l) and (m), the department may not require that income, deductions, and credits attributable to a taxpayer and another entity not described in subsection (o)(1) or (o)(2) be reported in a combined income tax return for any taxable year, unless the department is unable to fairly reflect the taxpayer's adjusted gross income for the taxable year through use of other powers granted to the department by subsections (l) and (m).

Taxpayer described a corporate reorganization that began in 2001 with the goal of reassessing the group's cost-structure, driving efficiencies, and gaining economies of scale in a competitive market. As part of this reorganization, Taxpayer states that it formed ZZZ Co. in 2003. ZZZ Co. centralized services for the group, such as merchandising, inventory management, other procurement services, advertising, marketing, strategic planning, legal, treasury, cash management, tax, and accounting. ZZZ Co. provided Taxpayer with the creation of Taxpayer's retail environment. Taxpayer, in return, paid ZZZ Co. "an arm's length profit" based on Taxpayer's "retailing functions and risks." Taxpayer argues that the "arm's length" nature of the merchandise sales transactions between ZZZ Co. and Taxpayer was determined through a contemporaneous transfer pricing study conducted by a nationally recognized accounting firm in accordance with I.R.C. § 482. The transfer pricing study recommended a return of an invested capital ("ROIC") range for Taxpayer based on analysis of seven comparable companies. Taxpayer further argues that ZZZ Co. was responsible for Taxpayer's key value drivers: merchandising, inventory management, branding and differentiation, technology and fact-based decision making.

Taxpayer points out that Indiana law prohibits combining the income of two separate taxpayers unless the taxpayers' adjusted gross income cannot be fairly reflected by other means. IC § 6-3-2-2(o), (p). Taxpayer contends that the Department's auditor failed to set forth any basis for the position that Taxpayer's income was not already fairly reflected on its Indiana income tax returns. Taxpayer refers to the auditor's comparison of Holding's total sales attributable to Taxpayer to Holding's taxable income attributable to Taxpayer as a "specious comparison."

The Department's audit clearly demonstrated that the separate filing reporting of Taxpayer's Indiana adjusted gross income was seriously distorted. The Department's audit demonstrated that Taxpayer represented 99 percent of the group's revenue, but less than 10 percent of the income of the group. Taxpayer does not explain why it considers this a "specious" argument. The Department's audit demonstrated that Taxpayer's consolidated group was unitary. In particular Taxpayer and ZZZ Co. are so intertwined as to be inseparable, and Taxpayer does not contest that there is a unitary relationship. The Department requested additional information from Taxpayer numerous times through the audit which lasted for over a year, but while Taxpayer provided some of the information, the information provided was never complete, nor did it contain the requested underlying detail. Taxpayer did not provide the transfer pricing study to the Department's auditor, but rather suggested that the auditor was welcome to travel to its headquarters to peruse the study (Taxpayer finally provided the study after the hearing at the insistence of the Department). The Department's auditor, after the auditor sent Taxpayer draft copies of the audit's work-papers, properly solicited Taxpayer's input in determining a method that would fairly reflect Taxpayer's Indiana income subject to Indiana AGIT. Taxpayer insisted that its separate filing sufficiently reflected its Indiana income. Furthermore, Taxpayer confirmed to the Department's auditor that indeed the years at issue were under audit by the IRS, but Taxpayer did not provide the Department with the IRS' reports.

The Department's audit report contains a detailed analysis of Taxpayer's AGI before apportionment and after apportionment with ZZZ Co. and demonstrates that Taxpayer's Indiana income was substantially understated by filing a separate return. Taxpayer represents 99 percent of the group's revenues, but less than 10 percent of the income of the group. The Department's auditor provided to Taxpayer the three options it was considering in order to more fairly reflect Taxpayer's Indiana income, and requested Taxpayer's input: (1) to disallow a portion of the inter-company expenses between Taxpayer and ZZZ Co., (2) a limited combination of Taxpayer with ZZZ Co., or (3) a combination of the group's consolidated federal return. In the end, the Department's audit chose the second option for two primary reasons. First, because the auditor did not feel he had enough information to combine the federal consolidated group. Second, the auditor believed that selecting the first option failed to provide Taxpayer factor relief in the apportionment calculations. By selecting the second option, Taxpayer was afforded factor relief by the inclusion of ZZZ Co.'s components in the denominators of the apportionment calculations – an approach that fairly reflected Taxpayer's Indiana source income and which resulted in lower assessment to Taxpayer.

Taxpayer argues that the Department's audit report did not meet the requirements of IC § 6-3-2-2(l) which Taxpayer argues means that the Department can only apply the unitary business doctrine if the transactions are not conducted at arm's length. Even though, the Department's auditor was open to reviewing Taxpayer's transfer pricing study that purportedly established its arm's length rates for the intercompany transactions, Taxpayer failed to provide the study during audit. The Department's audit, however, concluded that even if the study substantiated Taxpayer's arm's length claim, still this would not preclude the Department from more fairly reflecting Taxpayer's Indiana source income on its Indiana return. After the hearing, Taxpayer did eventually provide a 2004 transfer pricing study. The study applied a "comparable profits" method of analysis with significant and detailed

modifications and concluded with a suggested arm's length range of 5.4 percent to 18.5 percent return of investment capital. Notwithstanding a possible expert deconstruction of the study's methodology, two facts are striking. First, the study itself is a 2004 study that analyzed "comparables" data for that year and the two preceding years and recommended in its concluding language that, given dynamic market fluctuations, Taxpayer redo the study annually. The Department's audit was for the years 2005, 2006, and 2007. Therefore, even if completely valid, Taxpayer's study does not reflect its industry's activity for at least two of the years at issue. Secondly, Taxpayer did not demonstrate which numbers it used to establish its arm's length rates.

IC § 6-3-2-2(l) is a "corrective" statute. The required combination brings in these two commonly-controlled, unitary entities in order to better reflect a proper apportionment of Indiana source income and thus reflect the substance of the business activity conducted in Indiana in light of the fact that Taxpayer's reporting for the years at issue did not "fairly represent" that activity.

FINDING

Taxpayer's protest is denied.

II. Tax Administration – Negligence Penalty.

DISCUSSION

The Department issued ten percent negligence penalties for the tax years in question. Taxpayer protests the imposition of the penalties. The Department refers to IC § 6-8.1-10-2.1(a)(3), which provides "if a person... incurs, upon examination by the department, a deficiency that is due to negligence... the person is subject to a penalty."

The Department refers to 45 IAC 15-11-2(b), which states:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The Department may waive a negligence penalty as provided in 45 IAC 15-11-2(c), as follows:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

Taxpayer has met its burden of proof to show that the deficiencies they incurred are due to reasonable cause and are therefore not subject to a penalty under IC § 6-8.1-10-2.1(a).

FINDING

Taxpayer's protest is sustained.

III. Tax Administration – Underpayment Penalty.

DISCUSSION

The Department issued proposed assessments and the ten percent underpayment penalty for the tax year in question under IC § 6-3-4-4.1(d). Taxpayer protested the imposition of underpayment penalty.

IC 6-3-4-4.1(d) states:

> The penalty prescribed by IC 6-8.1-10-2.1(b) shall be assessed by the department on corporations failing to make payments as required in subsection (c) or (f). However, no penalty shall be assessed as to any estimated payments of adjusted gross income tax which equal or exceed:
>
> (1) the annualized income installment calculated under subsection (c); or
>
> (2) twenty-five percent (25 [percent]) of the final tax liability for the taxpayer's previous taxable year.

In addition, the penalty as to any underpayment of tax on an estimated return shall only be assessed on the difference between the actual amount paid by the corporation on such estimated return and twenty-five percent (25 [percent]) of the corporation's final adjusted gross income tax liability for such taxable year.

Taxpayer has provided sufficient documentation demonstrating that the imposition of the underpayment penalty is not appropriate.

FINDING

Taxpayer's protest of the underpayment penalty is sustained.

CONCLUSION

Taxpayer's protest of the assessment of negligence and underpayment penalties are sustained. Taxpayer's protest of the required combination with its affiliate is denied.

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